FEDERAL-PROVINCIAL TAX COLLECTION AGREEMENTS:

RECENT PROVINCIAL COMPLAINTS

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The Joint Federal-provincial Tax Collection Agreements established in 1962 are now in their twenty-third year of operation. In General, these agreements have proven to be "sufficiently flexible to accommodate the needs of both the federal government and the provinces."[1]. In fact, the Canadian tax system stands out as a fine example of federal-provincial compromise and cooperation. Nevertheless, the Tax Collection Agreements are presently under a great deal of strain. Many provinces are quite frustrated with the approach the federal government has taken in recent years with respect to the shared tax structure. The three largest provinces remaining signitories to the Tax Collection Agreements (Alberta, British Columbia and Ontario) are now openly discussing complete withdrawal from the tax arrangements, threatening the entire system of federal collection of provincial income taxes.

This paper examines the nature of the provinces' recent discontent with the joint tax system, focusing on the case of Alberta - the only province in the last 25 years which has actually made its threat of pulling out of the system with respect to corporate tax a reality. Alberta has also documented its intention to implement its own collection system for personal income tax in the government's Proposals for an Industrial and Science Strategy for Albertans, 1985 to 1990. Although the government has said that it will allow time for the new federal government to fulfill its promises of job creation in western Canada before such a move would take place, official statements indicate that the province is giving serious consideration to this alternative. Some intermediate solutions to the present impasse will be offered for discussion in the latter part of this paper.

HISTORICAL PERSPECTIVE

In order to understand the background of the provinces'

discontent with the tax system, it is necessary to briefly outline some of the historical developments that underlie the current personal income tax (PIT) arrangements. This is not intended to be a complete history of taxation in Canada, rather the objective is to identify certain trends that have emerged in the post-war era with respect to taxation.

The underlying philosophy of the current tax collection agreements can be traced to the report of the Rowell-Sirois Commission of 1940, which was highly critical of the lack of tax coordination among jurisdictions in Canada. During the depression of the 1930s, several provinces entered the tax field for the first time. What resulted was a 'tax jungle'[2]: different levels of government (including municipalities) occupied the same tax field, tax rates were extremely high, and the rules used by the different governments were inconsistent. Only with the outbreak of World War Two was the federal government able to mount a campaign to retain control of direct taxation, arguing that it needed such control to finance the war effort and realize important stabilization objectives. Under the Wartime Tax Agreements, all provincial governments temporarily ceded their occupation of the income tax field in exchange for 'tax rental' payments from the federal government. These rental agreements were extended in 1947, after the war, with Ontario and Quebec being the only provinces choosing to establish their own corporate income tax systems. Later, for constitutional reasons, Quebec also chose to administer its own personal income tax system.

The tax rental agreements (1941-1957) are often praised for being far superior to the pre-war tax conditions because of the tax harmony achieved among the income tax structures of the various levels of government. In fact, this harmony

was actually imposed by the federal government, since under the agremeents the federal government set the tax rates and made payments to the provinces based on certain formulas. However, the history of tax agreements immediately following the war up to the present day arrangements illustrate the gradual breakdown of this harmony as provinces steadily regained control over direct taxation. In many ways the evolution of the personal income tax in Canada closely parallels the more general evolution of Canadian federal-provincial relations.

The transition from tax rental agreements to tax sharing agreements came about largely as a result of provincial pressures to increase their revenue yields. In the early tax rental agreements federal compensation to the provinces was not related directly to the potential revenues that could have been expected from a provincially administered tax. In responding to provincial complaints about revenue yields Ottawa modified the formulas used to calculate federal payments so that provinces could choose, among several options, the one which was best suited to their needs. By 1957, the provinces could either opt to impose taxes themselves at the "standard" federal rate or continue to "rent" the tax source to the federal government and receive payments based on the revenue the tax would have produced if imposed at the standard rate. This was the transitional step towards tax sharing, since federal compensation was now directly related to the revenues that would have been generated within their respective jurisdictions. Since this implied a much greater revenue yield for rich provinces as opposed to poor ones, the move toward full revenue sharing came in conjunction with the first equalization program.

Although the agreement to make payments based on actual revenues was reached in 1957, the provinces were still not allowed to set different levels of provincial taxes. Only those provinces operating outside the arrangements (Quebec and Ontario for corporate income taxes) could set taxes above the standard federal rate. In responding to pressures for greater provincial autonomy in setting provincial tax rates, the federal government, in 1962, agreed to allow the provinces to set their own levels of taxation. The federal government offered to reduce its share of personal and corporate income taxes and collect, free of charge, provincial taxes providing the provinces accepted the federal definition of the tax base. This represented a significant break from the past, since each province had the flexibility to set its own tax rate.

The 1962 tax collection agreements are now in their twenty-third year of operation. Currently, taxes on personal and corporation income vary considerably across the provinces. Provincial complaints pertaining to revenue yields are no longer a serious source of contention. Under the existing tax collection agreements, the federal government collects taxes for both levels of governments, and bears the entire administrative cost involved. (This description excludes Quebec, the only province with its own independent personal income tax system.) The nine participating provinces must accept the federal personal income tax structure including: the types of income subject to tax, exemptions and deductions from income, and the underlying marginal rates, bracket size, and the indexation factor.[3] The provinces cannot alter these definitions, and are restricted to simply supplying their tax rates as a function of the federal rate. Any province desiring a higher revenue can raise its tax rates as long as the rates are expressed in terms of the federal definition of taxable income.

From the preceding summary, it would appear that Ottawa

has been very flexible with the provinces in administering their income taxes. Since the end of the war Ottawa has made several concessions to the provinces in order to prevent them from abandoning the joint income tax system. Despite these concessions, some provinces feel constrained by what they perceive to be a lack of flexibility on the part of the federal government in administering the conditions of the tax agreements. Provincial complaints no longer focus on revenue amounts, but deal with an entirely different issue. It is unclear as to whether the federal government can continue to play a significant role in tax harmonization, since this most recent provincial complaint will be much more difficult to resolve than the past problems of constitutional rights and revenue amounts.

RECENT PROVINCIAL COMPLAINTS

Recent provincial complaints pertaining to the tax collection agreements focus on the use of the tax system to attain certain policy objectives. It is important to recognize that under the existing tax collection agreements the federal government determines the overall tax structure. The provinces are restricted to applying their tax rates to the 'basic federal tax'. Thus, provincial tax is in fact a surtax, or a "tax on tax", rather than a "tax on base".[4] Therefore, any action taken by Ottawa with respect to the definitions, regulations, exemption levels, etc., will automatically affect provincial tax policy. In effect, the provinces have a limited ability to influence the overall tax structure, and therefore, are left without the use of one major instrument of policy implementation. Naturally, they are not entirely satisfied with the situation.

This description must be clarified in light of one major development that has dramatically altered the provinces' ability to influence the PIT. Starting in 1972, the federal

government agreed to administer various tax credits and surcharges on behalf of the provincial governments. This initiative has taken on major significance for two reasons. Firstly, the development of tax credits has given the provinces greater flexibility in terms of influencing the progressivity of income taxes. Secondly, and more importantly, tax credits have increased the provinces' freedom to tailor their respective PITs according to the perceived needs of their province.

Initially these tax credits dealt with matters relating to income distribution and were designed to "establish norms of equity or alleviate specific instances of hardship."[5] For example, special reductions for low income taxpayers and surtaxes on the rich were introduced. However, towards the end of the 1970s, some provinces became more interested in developing tax credits that would promote provincial economic objectives or that would counter federal initiatives deemed undesirable by the province. In the case of Alberta, it is evident that the Alberta royalty tax rebate was implemented to offset the federal government's decision to disallow the deduction of crown royalties for the purpose of calculating corporate income taxes. Alberta regards royalty payments as a legitimate business expense. Consequently, the province believes they should be subtracted from gross income just as any other type of business expense. The royalty tax rebate allows the province to give a deduction on provincial taxes for Crown royalties paid, and in effect, altered the federal definition of taxable income.

By the end of the 1970s, the federal government had become increasingly concerned about administering tax credits which either altered the federal definition of taxable in-

come or which interfered with the free flow of goods and capital across provinces. Provincial measures which gave preference to certain forms of economic activity within prcvincial boundaries were perceived by Ottawa as threatening the harmony and uniformity of the joint tax collection system. Consequently, Ottawa issued a more restrictive set of guidelines in determining whether or not a provincial tax credit would be administered under the Tax Collection Agreements. Specifically, the criteria outlined by Ottawa were threefold:

1. The measure must be able to be administered reasonably effectively.
2. The measure must not significantly erode or have the potential to erode the essential harmony and uniformity of the federal and provincial income tax system.
3. The measure must not jeopardize the efficient functioning of the Canadian economic union by the erection of barriers to normal interprovincial investment flows.[6]

The first proposal to be rejected by Ottawa was British Columbia's attempt to have Ottawa administer a dividend tax credit and a small business venture capital corporation tax credit. This initiative was based on the highly successful Quebec Stock Savings Plan which allows Quebec taxpayers to reduce their taxable income by deducting amounts (up to $15,000) invested in newly issued shares of Quebec-based corporations. Naturally, other provinces viewed this program as an excellent way of providing capital for business investment and many provinces attempted similar initiatives. However, and not surprisingly, Ottawa rejected the B.C. proposal on the grounds that it would "erect barriers to the free flow of capital across boundaries."[7] The message

came through loud and clear - the cost of participating in the joint collection agreements was the loss of freedom to use the tax system to promote provincial policy objectives. Quebec could pursue such tax policies simply because it was not party to these arrangements. Largely as a result of this, B.C. indicated some interest in withdrawing completely from the tax collection agreements.

The provincial governments felt that Ottawa was being unreasonable for two reasons. Firstly, many federal initiatives (for example the activities of DREE) were also aimed at influencing investment decisions and counteracting market forces. Secondly, the same provincial programs could be implemented through other measures, such as direct expenditure programs. In fact, Ottawa appeared not to object to the underlying rationale behind these provincial development incentives, it simply did not want the programs to be incorporated into the personal income tax system. Indeed, when Alberta attempted to have Ottawa administer a Rental Income Tax Credit, Ottawa rejected the measure but suggested "that Alberta could implement such a program outside the PIT system."[8] The program was later introduced under the guise of the Department of Housing and Public Works Act. Other provinces (Saskatchewan and Ontario) have also introduced provincial development incentive programs outside the PIT system which accomplish essentially the same thing as economic development incentives through the tax system.

The events of the 1970s and early 1980s reveal two important trends in the area of federal-provincial taxation. First, provincial governments have become increasingly aware of the allocation effects tax policy can have on investment

decisions in the province. Second, as a result of this heightened awareness, many of the provinces feel strongly about the need to use the tax system, as opposed to other methods, as a means to pursue various economic policies. In part, this is a result of depressed economic conditions and weakened economic prospects but it is also tied in with the whole notion of province building. In any event, these trends have put new strains on the tax collection agreements. Presently, the three provinces most concerned with the question of taxation as a policy tool are the three largest (outside of Quebec) and the three riches provinces. If these provinces were to withdraw from the tax collection agreements, the implications for tax harmonization and the maintenance of an internal common market would be enormous.

From the federal government's standpoint, the problem is one of reconciling two opposing interests. In attempting to maintain some degree of tax harmonization it must insist upon strict guidelines in administering the tax collection agreements. However, by denying the provinces the flexibility to enact special measures aimed at influencing investment within the province, it runs the risk of inducing some provinces to set up their own tax systems.

From a provincial standpoint the problem is one of making a decision. If the federal government is unwilling to allow provinces to use the income tax system to implement discriminatory economic policies, the provinces have two options. They can remain party to the tax agreements and implement development policies outside the PIT system. Alternatively, they can withdraw from the agreements and use the tax system as an instrument to pursue provincial development policies, accepting all the associated costs of such action

(including the risk of retaliation by other governments).

ALBERTA'S WITHDRAWAL

In order to understand why Alberta adopted its own corporate income tax and why it is presently considering adopting an independent personal income tax, one must understand the province's views with respect to taxation.

Between the official announcement to withdraw from the corporate tax agreements in 1974 and the final implementation of The Alberta Corporate Income Tax Act in 1981, the province devoted itself to developing a corporate tax incentive package aimed at promoting economic diversification.[9] The province's decision to withdraw was clearly based on the belief that the only way to implement effective provincial diversification policies was by operating outside the tax collection agreements. In his 1974 speech to the Alberta Legislature, Premier Lougheed outlined some of the advantages of an Alberta-administered corporation income tax. Among these advantages were the following:

- It would permit Alberta to design a tax system to allow reduced tax for small and locally-controlled business and service companies all across this province to help them to expand, diversify and compete with large national and international competitors ...
- It could provide an effective vehicle to stimulate and encourage companies producing our oil and natural gas to process and upgrade the production in Alberta to the fullest extent practical ...
- It could encourage the reinvestment in Alberta of profits earned in Alberta - and this would particularly be the case with regard to the larger petroleum companies.

- It could encourage agricultural production to be processed in Alberta and then shipped in an upgraded form and hence, indirectly strengthen the family farm and the province.
- It could encourage companies earning a significant portion of their profits in Alberta to either have their head office located in Alberta ...
- It could tend to increase the degree of Alberta control of business operating within this province yet not preclude a continuation of appropriate investment from other places. In particular, it could encourage Alberta companies to sell shares to Albertans to the extent practical to do so.[10]

Alberta's withdrawal was unlike the earlier withdrawals of Quebec and Ontario, which were done for constitutional and revenue reasons. The uniqueness of Alberta's decision is the fact that it was based solely on the perceived need to use the tax system to attain certain policy objectives. "It is clear that tax policy must support our economic strategy and be an instrument to achieve our goals."[11] The province's position relating to the use of the personal income tax system reiterates the same message. In the government's Proposals for an Industrial and Science Strategy for Albertans, 1985 to 1990, the government states that "Tax incentives will be used to stimulate new jobs and secure jobs in Alberta, by being able to encourage investment in specific ways tailored to Alberta's unique stages of development."[12]

The fact that the Alberta government views taxation as a valuable instrument for the implementation of policy objectives is not unusual "provincial economic policies throughout Canada generally aim at increasing investment and jobs within the province, even if that means reducing investment and jobs in other provinces."[13]The interesting aspect of Alberta's

position lies in the fact that the government believes that measures introduced through the tax system are preferable to measures introduced outside the system, even though both types of policy instruments are aimed at influencing the same economic behaviour. This position is directly linked to the government's free-market ideology. Taxation is considered to be more consistent with allowing the market to determine economic behaviour. The main alternatives to tax incentives are direct expenditure programs and regulations. However, the Alberta government has serious reservations about using either of these two instruments. Direct expenditure programs require the province to make available grants through the Treasury Department to individuals and businesses often prior to the activity being undertaken. Consequently, grants tend to reward economic activity rather than success. Regulations, on the other hand, tend to be very"restrictive, interventionist, discretionary, and require a large bureaucracy to administer."[14] The advantages of tax incentives, in Mr. Lougheed's view, are two-fold:

1. The tax system is most suited to delivering broadly-based policy; its nature mitigates against the detailed fine-tuning usually found in grants.
2. Tax incentives limit the extent of direct government involvement and leaves decision making responsibility appropriately with the private sector.[15]

Whether or not the Premier's view is supported by empirical reality is a matter of debate; experts in the field are divided on the issue. Nevertheless, this was the underlying rationale behind the government's decision to withdraw from the tax collection agreements with respect to corporate income tax in 1981, and continues to be a motivating factor in the government's present discussion about pulling out of the agreement

on personal income tax. Provincial Treasurer Lou Hyndman acrticulates the province's position "federal criteria do not allow us to use the personal income tax to implement unique Alberta programs ... we can use less preferable instruments or terminate to agreement and administer our own tax."[16]

CONCLUSION

The establishment of the Quebec Stock Savings Plan through the Quebec personal income tax system in 1979 demonstrated to Alberta, and other provinces, what can be accomplished through a provincially administered tax system. Quebec has been able to introduce development incentives by way of the tax system that have been the envy of other provinces. In Alberta's case these investment incentives are particularly attractive in light of the province's commitment to diversify the provincial economy. The Alberta economy is subject to many external limitations: Alberta's principal products are sold at prices determined by market forces outside Canada, export market accessibility is subject to tariff and non-tariff barriers beyond its control, interest rates are determined by decision-makers outside the province, and because Alberta is landlocked its products bear a high transportation cost compared to its competitors. All of these constraints make diversification by the private sector alone extremely difficult. This is the very reason the provincial government feels so strongly about the need to develop an overall strategy which would include tax incentives for diversification. Tax incentives could (theoretically) induce investment to flow to certain segments of the economy "even though, given the current market structure, investment would flow elsewhere - perhaps elsewhere in Alberta but, more likely, elsewhere in Canada." [17]

The most obvious advantage of an Alberta-administered

personal income tax would be the increased leverage to tailor Alberta's tax system according to the unique structure of the provincial economy.[18] A separate personal income tax would also allow the province to reject certain federal initiatives relating to personal income tax if those measures were seen to be detrimental to the province's best interests or even increase the province's bargaining power vis-a-vis the federal government. Certainly there are several other compelling reasons why the province should consider opting out of the joint tax collection agreements. However, many of these arguments, being very narrow in focus, do not take into account the macro-economic implications that would attend a decision by Alberta to implement its own personal income tax. Other provinces would likely respond with retaliatory "beggar - thy - neighbour"[19] policies leaving all participants worse off in the long run. Even if the Alberta government feels it is able to withstand retaliation by other provinces there are several other significant costs associated with such a move. One of these costs is the risk of complicating the entire system and creating a whole new level of government bureaucracy.

Given that a decision to withdraw from the tax collection agreement on personal income tax would probably be irreversible, it is to the advantage of all parties concerned to explore the range of alternatives that exists between the two extremes. Intermediate solutions to the present difficulties that would partially satisfy provincial demands without endangering the single collection system must be examined. The Ontario Economic Council has highlighted several alternative solutions in its report on the Personal Income Tax Reference in order to demonstrate that the decision is not an all-or-nothing choice.[20] The council concludes by stating that:

> "A separate PIT is not in the immediate interests of the Province of Ontario. There are too many alternative options yet open to the province to justify such a move." 21

Solutions to the present situation must come from both directions - the provincial governments and the federal government. For example, Ottawa could agree to administer a certain number (i.e. two per province) of special provincial tax measures. The federal and provincial governments could also arrive at a joint agreement on the determination of a common tax base, with both parties being able to modify the base to suit their own needs. The essential point is that since some of the benefits of an independent personal income tax system can be achieved without such "drastic institutional change",[22] every effort should be made to reach a compromising solution.

The three provinces currently voicing the strongest discontent with the tax collection are Ontario, British Columbia and Alberta. If these three provinces choose to withdraw, there would no longer be any reason for a single collection system. Eighty per cent of Canada's population would live in provinces that collect their own income taxes. In terms of Canadian federalism, the whole process could"unravel into an interjurisdictional rivalry, resulting in the fragmentation of the internal common market".[23]

This paper has only briefly examined the nature of the provinces' discontent with the joint tax system. A decision by any one province to institute a separate personal income tax will have far reaching effects for the entire country. It is hoped that tne analysis offered for discussion here will generate further interest in, and research into, this topic.

FOOTNOTES:

1. Ontario Economic Council, A Separate Personal Income Tax for Ontario, p. 9

2. Abizadeh and Hudson, Trends in the Federal-Provincial Tax Collection Agreements, Canadian Tax Journal, vol. 31, p. 654

3. Ontario Economic Council, P. 7

4. Ontario Economic Council, p. 7

5. Perry, Background of Current Fiscal Problems, p. 58

6. Ontario Economic Council, p. 22

7. Honourable Allan MacEachen, Federal-Provincial Fiscal Arrangements, p. 33

8. Ontario Economic Council, p. 30

9. Alberta, Legislative Assembly, Alberta Hansard (April 2, 1974) p. 888-92

10. Ibid, P. 888-92

11. Alberta, Basic Objectives and Terms of Reference, (Provincial Treasury) p.10

12. Alberta, Proposal for an Industrial and Science Strategy for Albertans 1985-1990, p.63

13. Abizadeh, p. 662

14. Alberta Hansard (April 2, 1974) p. 888

15. Alberta, The Road to Recovery, p. 10

16. Abizadeh, p. 663

17. Abizadeh, p. 664

18. Ontario Economic Council, p. 146

19. Ontario Economic Council, p. 111

20. Ontario Economic Council, p. 139

21. Ontario Economic Council, p. 163

22. Ontario Economic Council, p. 139

23. Ontario Economic Council, p. 110

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2. Alberta, Basic Objectives and Terms of Reference for Alberta Business Taxation (Edmonton: Provincial Treasury, 1975)

3. Alberta, Legislative Assembly, Alberta Hansard (Edmonton: May 22, 1980), p.1114

4. Alberta, Proposals for an Industrial and Science Strategy for Albertans, 1985-1990 (Government of Alberta: July 1985)

5. Alberta, The Road to Recovery: Restoring Investor Confidence (Edmonton: August 1982)

6. Honourable Allan MacEachen, Federal-Provincial Fiscal Arrangements in the Eighties, a Submission to the Parliamentary Task Force (Ottawa: Department of Finance, April 1981)

7. Ontario Economic Council, A Separate Personal Income Tax for Ontario, Ontario Economic Council Position Paper, March, 1983

8. J. Harvey Perry, Background of Current Fiscal Problems, Canadian Tax Paper No. 68 (Toronto: Canadian Tax Foundation, 1982)